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A Review of Bangladesh's External Sector Performance

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Micro Impacts of Macroeconomic and Adjustment Policies in Bangladesh Project

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I. Introduction

Like its South Asian neighbors, Bangladesh began with a restricted trade and exchange rate policy ostensibly to (a) conserve scarce foreign exchange; (b) create industrial base through protective domestic environment; and (c) maintain the balance of payments at a sustainable level. The outcome of such protective policies was, however, disappointing: it created a distorted incentive structure resulting in allocative and productive inefficiencies. The policies also gave rise to anti-export bias discouraging the growth of exports. To redress the anti-export bias, special incentive schemes were designed which were also expected to minimize inefficiencies through domestic competition.

The outcomes of these inadequate and commodity-specific measures, however, were not encouraging in terms of export development, balance of payments and the development of the overall economy. Disenchanted with such autarkic external sector strategy and also prompted and dictated by the Bank – Fund conditionalities, the policymakers in Bangladesh, as elsewhere in the South Asian countries, began to shift the balance towards more openness of the economy since the late 1970s. The move was gradual till early 1990s. Trade liberalization in Bangladesh in the early 1990s was rather swift compared to many of its South Asian neighbors. Despite such a rapid transition, a vibrant export-led growth was not achieved that could take care of chronic balance of payments crises. It is, therefore, useful to examine the country's external sector performance and identify factors that inhibited the emergence of a viable external sector.

The present study reviews the reforms in trade and exchange rate policies in Bangladesh that has been carried out since independence and the impact of these reforms on the external sector. The paper is organized as follows: section II analyzes the trade balance and its decomposition into determining components. Section III examines the trend in the growth of exports while section IV analyzes the composition of exports and imports. Section V gives a succinct review of the export incentives followed by a review of the import policies in Section VI. Section VII provides a chronological account of the exchange rate regime. Some concluding remarks are presented in section VIII.

II. A Review of Trade Balance

The problem of balance of trade in Bangladesh is well known: ever since the independence of the country, export earnings have persistently fallen behind import payments. Consequently, every year the country incurs a huge trade deficit (Table 2.1). To arrest the yawning gap, the policymakers pursued various policies apparently with inadequate knowledge about the nature and extent of influence of the putative factors. An attempt has been made in this section to isolate and analyze the underlying factors. It is expected that such a decomposition will help the policymakers address the underlying issues and formulate appropriate policies.

Table 2.1
Bangladesh: Trade Balance and Export-Import Price Indices

Year	Value (Tk. Million)			Price Indices (1984/85 = 100)	
	Exports[a]	Imports[a]	Trade Balance[a]	Exports[b]	Imports[b]
1973/74	2,983	7,320	-4,337	46.8	49.0
1974/75	3,136	10,842	-7,706	57.9	64.2
1975/76	5,552	14,703	-9,151	50.7	58.2
1976/77	6,670	13,993	-7,323	56.1	57.7
1977/78	7,178	18,216	-11,038	64.4	59.1
1978/79	9,632	22,073	-12,441	80.4	68.7
1979/80	10,997	30,525	-19,528	97.0	87.4
1980/81	11,484	37,288	-25,804	80.0	102.6
1981/82	12,387	38,729	-26,342	68.7	107.1
1982/83	18,016	45,265	-27,249	69.9	101.5
1983/84	20,136	50,874	-30,738	82.5	100.1
1984/85	26,225	68,263	-42,038	100.0	100.0
1985/86	27,396	62,929	-35,533	72.5	88.9
1986/87	33,682	68,496	-34,814	75.2	81.1
1987/88	41,161	91,588	-50,427	88.0	82.5
1988/89	42,686	95,075	-52,389	85.1	87.7
1989/90	41,515	113,305	-71,790	87.9	93.0
1990/91	60,272	111,877	-51,605	93.7	96.9
1991/92	74,198	132,756	-58,558	92.3	94.2
1992/93	88,215	138,198	-49,983	98.6	97.3
1993/94	98,739	137,540	-38,801	104.1	100.0
1994/95	136,970	218,564	-81,594	111.0	108.9
1995/96	144,521	254,646	-110,125	118.5	116.9
1996/97	171,554	290,187	-118,633	124.1	120.4
1997/98	229,408	318,916	-89,508	128.9	124.5
1998/99	245,620	341,016	-95,396	129.2	130.9
1999/00[c]	289,383	422,755	-133,372	129.9	142.6

Sources: a. BBS, Foreign Trade Statistics (various issues)
b. Bangladesh Economic Survey (various issues)
c. Bangladesh Economic Survey, 2001

The yearly change in the balance of trade is the result of underlying changes in price or quantity or both. The change in trade balance resulting from changes in volume at unchanged prices can be attributed to volume effect. In effect, the volume effect is a reflection of the gross

barter terms of trade. Similarly, the change in trade balance resulting from changes in prices at unchanged volume is attributable to total price effect. The total price effect can further be decomposed into terms of trade effect (or relative price effect) and inflation effect (or general price level effect). The terms of trade effect includes changes in the balance of trade attributable to changes in the relative prices of exports and imports that at unchanged volume alter the net barter terms of trade. Conversely, the inflation effect includes changes in the balance of trade attributable to changes in the overall prices of exports and imports, which at unchanged volume keep the net barter terms of trade constant. It is the residual of the terms of trade effect subtracted from the total price effect. The difference between the changes in trade balance and the sum of volume and total price effect is termed as residual effect of several unknown and/or less important factors. A positive (negative) value of a component signifies contribution of that component towards balance of trade improvement (deterioration).

The decomposition analysis of trade balance has two interpretations in the relevant literature. One strand follows Baldwin (1955) and Kindleberger (1956) which was applied by Rahman (1979) on the erstwhile East Pakistan data between 1959/60 and 1968/69 and for the early years of Bangladesh ranging from 1972/73 to 1974/75. The other strand follows Stuvel (1956). Hossain (1991), among others, applied this methodology for the Bangladesh data till 1990s. There are, however, some methodological limitations in both studies applied to Bangladesh. Rahman (1979) only mentioned the residual effects in year-to-year changes in the balances of trade which he did not compute in his analysis. On the other hand, Hossain (1991) ignored the residual effects in his analysis. Moreover, he estimated total price effects indirectly. In contrast, the present analysis computes both volume and price effects directly along with residual effects. For the purpose, the simple analytics of a change in the balance of trade has been used.

Let $B_t = P_t^x Q_t^x - P_t^m Q_t^m$, be the balance of trade in year *t*, where x denotes exports, m is imports, P denotes prices, Q denotes quantities and t is the time subscript. Now consider a change in B between year *t* and *t-1* denoted as

$$\Delta B = B_t - B_{t-1} = \left(P_t^x Q_t^x - P_t^m Q_t^m\right) - \left(P_{t-1}^x Q_{t-1}^x - P_{t-1}^m Q_{t-1}^m\right)$$
$$= \left(\Delta P_t^x + P_{t-1}^x\right)\left(\Delta Q_t^x + Q_{t-1}^x\right) - \left(\Delta P_t^m + P_{t-1}^m\right)\left(\Delta Q_t^m + Q_{t-1}^m\right) - \left(P_{t-1}^x Q_{t-1}^x - P_{t-1}^m Q_{t-1}^m\right)$$

$$= \left(\Delta P_t^x Q_t^x - \Delta P_t^m Q_t^m\right) + \left(P_t^x \Delta Q_t^x - P_t^m \Delta Q_t^m\right) + \left(\Delta P_t^x \Delta Q_t^x - \Delta P_t^m \Delta Q_t^m\right) \quad (2.1)$$

The first term in equation (2.1) denotes price effect. The terms of trade effect and the inflation effect are embedded in this term. The second term denotes volume effect and the third term denotes the residual effect. The terms of trade effect is measured as:

$$\left(P_t^x Q_t^x - P_t^m Q_t^m\right) - \Phi\left(P_{t-1}^x Q_t^x - P_{t-1}^m Q_t^m\right) \quad (2.2)$$

where Φ is the chain Paasche index of export and import prices.

Table 2.2 shows that year to year changes in the balance of trade have been very uneven – marked by both small and large changes. There were very little changes in the balance of trade both in 1981/82 and 1982/83: the deficits remained roughly at the 1980/81 level. The deterioration of the balance of trade in the first of the two years was due to depressed prices which was mostly matched by an improvement in volume. The depression in prices was due to deterioration in the terms of trade overwhelmingly outweighing the mild improvement in the level of inflation.

The situation in 1982/83 as well as during the first year after the implementation of the reform programmes under the Structural Adjustment Facility of the World Bank and the IMF (i.e., 1986/87) was a mirror image of the previous year. The positive price effect was counterbalanced by the negative volume effect to keep the deficits roughly constant. The largest improvement in the balance of trade occurred in 1997/98 which was a reflection of the improvement in the volume of exports accompanied by an improvement in the terms of trade. Improvement in these factors more than counterbalanced the negative impacts of inflation. Conversely, the largest deterioration in the balance of trade occurred in 1999/00 due to negative influence of four of the five factors while the weak residual factors could not counteract the forces of other four factors.

Table 2.2
Decomposition of Changes in the Trade Balance

Year	Changes in Trade Balance	Volume Effect	Price Effect	Terms of Trade Effect	Inflation Effect	Residual Effect
1974/75	-3369.0	-1394.1	-2635.1	-290.1	-2345.0	660.1

1975/76	-1445.0	-2171.1	682.7	-282.2	964.9	43.4
1976/77	1828.0	1067.3	827.8	969.7	-141.9	-67.1
1977/78	-3715.0	-4231.9	645.7	1162.0	-516.3	-128.8
1978/79	-1403.0	-221.9	-1211.0	932.4	-2143.5	30.0
1979/80	-7087.0	-2445.2	-6027.1	-858.5	-5168.6	1385.3
1980/81	-6276.0	1711.8	-8525.4	-6780.5	-1744.8	537.6
1981/82	-538.0	3140.0	-3459.4	-3861.2	401.8	-218.7
1982/83	-907.0	-3733.0	2702.0	1832.0	870.0	124.1
1983/84	-3489.0	-7295.0	4348.6	4982.0	-633.5	-542.6
1984/85	-11300.0	-15941.3	5610.3	6985.5	-1375.2	-968.9
1985/86	6505.0	9028.9	-543.1	-8069.8	7526.7	-1980.8
1986/87	719.0	-7027.6	7218.4	5625.8	1592.5	528.2
1987/88	-15613.0	-20088.4	5466.2	7754.4	-2288.2	-990.8
1988/89	-1962.0	5140.2	-7415.9	-5662.7	-1753.3	313.7
1989/90	-19401.0	-14323.5	-5416.0	-1594.0	-3822.0	338.5
1990/91	20185.0	21042.1	-807.3	1716.8	-2524.1	-49.8
1991/92	-6953.0	-9659.3	2616.1	1282.7	1333.3	90.2
1992/93	8575.0	7261.0	1561.9	3692.1	-2130.2	-247.9
1993/94	11182.0	9677.1	1693.6	3092.3	-1398.6	-188.8
1994/95	-42793.0	-33370.0	-10461.9	-3626.8	-6835.0	1038.9
1995/96	-28531.0	-20308.5	-8875.2	-1009.8	-7865.4	652.7
1996/97	-8508.0	-7776.0	-620.7	3564.6	-4185.3	-111.3
1997/98	29125.0	31023.3	-1921.6	1232.0	-3153.6	23.3
1998/99	-5888.0	10111.2	-16857.0	-13572.8	-3284.2	857.7
1999/00	-37975.8	-4625.8	-36461.4	-27990.7	-8470.8	3111.4
Average	-4962.9	-2131.1	-2994.8	-1106.7	-1888.1	163.1
St. Dev.	15174.2	12962.6	8639.7	7140.0	3204.1	892.5
C.V.	-3.1	-6.1	-2.9	-6.5	-1.7	5.5

Source: Author's calculation based on data in Table 2.1

It can be seen that the volume effect was negative in 10 out of the 26 years considered in the present analysis . There was, however, no secular trend. The deterioration in the component was associated with a deterioration in the balance of trade in all years except 1986/87. On the other hand, the improvement in the component was associated with an improvement in the balance of trade in 60 percent of the cases. It implies that while deterioration in volume of trade frequently leads to deterioration in balance of trade, improvement in the component is less likely to lead to an improvement in the trade balance.

The price component declined in around 60 percent of the years. In most cases, a deterioration in prices leads to deterioration in the balance of trade. This negative effect, however, was not dominant in changing the balance of trade since its negative contribution was much less (at about one-third) than the volume of trade. However, the variability in volume effect was somewhat

higher than that of the price effects. Moreover, the variability of price effects was contributed more by variability in the terms of trade than that of inflation.

Table 2.3
Correlation between Changes in Trade Balance and Various Components

Factors	Trade Balance	Volume Effect	Price Effect	Terms of Trade Effect	Inflation Effect
		1974/75-1990/00			
Volume Effect	0.85				
Price Effect	0.53	0.01			
Terms of Trade Effect	0.39	-0.12	0.94		
Inflation Effect	0.56	0.29	0.61	0.29	
Residual Effect	-0.50	-0.13	-0.79	-0.63	-0.72
		1974/75 – 1985/86			
Volume Effect	0.796				
Price Effect	0.012	-0.587			
Terms of Trade Effect	-0.515	-0.894	0.747		
Inflation Effect	0.759	0.487	0.286	-0.424	
Residual Effect	-0.434	-0.085	-0.559	0.051	-0.835
		1986/87 – 1999/00			
Volume Effect	0.868				
Price Effect	0.554	0.068			
Terms of Trade Effect	0.470	-0.018	0.976		
Inflation Effect	0.631	0.309	0.742	0.578	
Residual Effect	-0.568	-0.150	-0.905	-0.909	-0.592

Source: Author's calculation.

Mean values of changes in the balance of trade together with its putative factors over the period imply that (i) changes in trade volume was the dominant factor underlying changes in the balance of trade; (ii) deteriorating price effect adversely affected the balance of trade; and (iii) the deteriorating price effect was largely attributable to the deteriorating terms of trade as the country was mainly an exporter of primary commodities. These observations could be vindicated by calculated balances of simple correlation coefficients given in Table 2.3. The value of correlation coefficient between changes in the balance of trade and changes in trade volume is 0.85. This implies that deterioration in trade volume is highly likely to lead to significant deterioration of the balance of trade. In contrast, the value of correlation coefficient between the balance of trade and price component is 0.53. It implies that as price level plummets the balance of trade deteriorates. The impact on the balance of trade becomes more pronounced when volume and price effects reinforce each other. However, such an incident is highly unlikely, as the correlation coefficient between the two variables is 0.01. Within the total price effect, inflation effect dominates. Here also the mutual

reinforcement is low as implied by the correlation coefficient of 0.29. It may be noted that the residual effect is highly negatively correlated with the balance of trade and with all of the underlying factors except trade volume.

III. Growth of Exports

Bangladesh's total exports got a significant boost with an annual trend growth rate of 14.24 percent during 1985/86 to 1999/00, compared to an annual trend growth rate of below 10 percent (in nominal US dollar terms) over the earlier period of 1972/73 through 1984/85. Such a pattern of export growth over time largely reflects the effects of progress in Bangladesh's policy reforms over the period. However, autonomous factors such as a persisting low world demand or declining demand for Bangladesh's major export products during the earlier period (e.g. jute and jute goods) did have a significant effect in limiting the overall export growth, especially starting with the mid-1980s. The export upturn in the latter period also reflects the fact that the export setback in jute and jute goods was more than recouped by remarkable growth in the export of a new product group, ready-made garments.

Among jute and jute goods, only **jute goods** had a statistically significant low annual trend growth rate of more than 6 percent during the early period and around 1 percent for the entire period. In the latter period, (1985/86 to 1999/00), it had no significant growth trend. **Raw jute** exports, on the other hand, had statistically significant negative growth trends for the whole period as well as for the second period. The negative trend accentuated in the later period while it was marginally positive in the earlier period. The reasons for the decline were the growth of jute manufacturing industry in the country and falling demand for raw jute in developed countries due to extensive use of synthetic fibers (Hossain, 1996).

Frozen food (mainly frozen shrimps) was one of the major product groups, which had a highly satisfactory trend growth rate of 16.11 percent for the whole period. However, its growth remained uneven, a spectacularly high rate of 31 percent during the period till 1984/85 along with a sharp drop to about 8.4 percent during 1985/86 to 1999/00. The drop in the growth rate in the later period may be attributed to a fall in demand in the EU markets in the late 1980s and early 1990s, which recovered only during the second half of the 1990s. The dwindling growth of frozen foods in the later period may also be attributed to supply constraints.

Tea falls in the category of an exceptional export product since it had a significant growth of 13 percent during the early period up to 1984/85. However, its growth was so low and erratic subsequently that it showed a negative growth trend during the later period. While Bangladesh successfully recouped the loss of tea export earnings caused by the dislocation during the country's war of Independence, it lost the momentum in its race with India and Sri Lanka in the late 1980s and early 1990s.

Bangladesh's exports of hides, skins, and **leather, and leather products** have increased since the early 1970s. The product group, included in the traditional export category, had a trend growth rate of about 9 percent during the entire period, which was close to the average growth for all exports. Its growth rate was more than 13 percent during the first period but the rate slowed to 5 percent during the second period.

Starting from a virtually zero base during the late 1970s, **readymade garments** exports grew at a very rapid rate of about 95 percent during the early period up to 1984/85, and, from a sizeable base, at a moderate but fairly high rate of 20.37 percent during the later period. **Knitwear** products newly entered the export market with some significance only in 1989/90 and since then its export grew very rapidly – at a much faster rate than other readymade garments. The very fast growth of the RMG product group as a major export earner (in gross terms) was the most remarkable development for Bangladesh, and without this phenomenal growth, Bangladesh's total exports which had a setback in the traditionally important exports of jute and jute goods, could not have grown at double digit in the late 1980s and 1990s.

Table 3.1
Annual Growth Trends of Exports by Commodity Groups

Commodity Group	1972/73 – 1999/00	1972/73 – 1984/85	1985/86 – 1999/00
Raw Jute	-1.75	0.71	-2.13
Jute Manufactures	1.22	6.49	1.01
Frozen Foods	16.11	30.58	8.4
Tea	1.75	13.23	-0.95
Leather	8.86	13.2	4.88
Readymade Garments*	57.10	94.91	20.37

Others	19.02	23.18	24.39
Total Exports	10.91	8.6	14.24

Source: Author's estimation based on Bangladesh Bank data.
Note: * The series starts from 1979/80.

If one looks at the growth of the **residual exports category** – all exports except jute and jute goods, frozen foods, tea, leather and leather products, and RMG – one finds a secular growth of 19 percent during the entire period. The trend was slightly lower at 23 percent up to 1984/85 compared to 24 percent in the second period till 1999/00.

IV. Changes in Composition of Exports and Imports

The highly disparate growth patterns of individual export product groups have inevitably led to large changes in the export composition over time. The composition is shown in Table 4.1. Certain changes may be noted as follows:

Exports of **traditional goods** (composed of jute, jute goods, tea and leather), constituted most of Bangladesh's total exports, around 97 percent in 1972/73. These exports precipitously fell to less than 10 percent in 1999/00. At present the dominance of raw jute and jute goods in the export trade of Bangladesh has weakened considerably, and some non-traditional items have made inroads. For example, the share of raw jute in export earnings has declined from about 38 percent in 1972/73 to a meager 1 percent in 1999/00. Over the same period, the share of jute goods declined from 52 percent to less than 5 percent. Another traditional exports item, **tea**, declined from 2.7 percent to 0.3 percent during the period. Tea's relative export share did increase in some of the years in the 1980s but it declined sharply in later years. **Leather's** share in total exports showed a significant increase from 4.6 percent in 1972/73 to more than 10 percent in the late 1980s but declined to a level of 3.4 percent in 1999/00.

Table 4.1
Composition of Exports by Commodity Groups

(% of Total Export Earnings)

Year	Raw Jute	Jute Goods	Frozen Foods	Tea	Leather	Readymade Garments	Others
1972/73	37.78	52.25	0.86	2.73	4.57	-	1.80
1973/74	34.73	52.73	1.21	3.98	4.31	-	3.05
1974/75	24.10	58.48	0.78	6.25	7.06	-	3.34
1975/76	33.27	47.76	2.85	4.67	8.12	-	3.33
1976/77	28.21	42.92	4.19	8.93	9.39	-	6.36

1977/78	19.63	50.41	3.94	9.17	9.19	-	7.66
1978/79	23.48	45.24	5.63	6.69	12.37	-	6.60
1979/80	19.87	53.22	5.13	4.56	9.08	0.09	8.05
1980/81	16.73	50.24	5.62	5.72	7.98	0.46	13.26
1981/82	16.22	45.22	8.42	6.05	10.06	1.12	12.91
1982/83	16.03	44.61	10.50	6.71	8.45	1.58	12.12
1983/84	14.26	40.89	11.56	8.38	10.37	3.84	10.70
1984/85	16.14	39.35	9.29	6.53	7.47	12.44	8.78
1985/86	15.24	36.21	14.11	4.03	7.47	16.17	6.77
1986/87	9.69	25.59	12.49	2.76	12.56	27.82	9.10
1987/88	6.54	21.52	11.34	3.15	11.95	35.24	10.24
1988/89	7.56	18.92	10.99	3.10	10.65	36.63	12.13
1989/90	8.18	18.69	9.05	2.59	11.74	39.97	9.78
1990/91	6.07	10.41	8.26	2.52	7.82	42.83	22.10
1991/92	4.29	14.71	6.40	1.62	7.25	53.36	12.37
1992/93	3.14	12.26	6.93	1.73	6.25	52.05	17.62
1993/94	2.26	11.21	8.34	1.50	6.66	50.97	19.06
1994/95	2.08	9.21	8.63	0.95	5.83	52.98	20.32
1995/96	2.32	8.49	8.10	0.86	5.45	50.23	24.55
1996/97	2.63	7.20	7.28	0.87	4.41	50.62	26.99
1997/98	2.09	5.43	5.76	0.91	3.67	54.97	27.17
1998/99	1.35	5.71	5.15	0.73	3.16	56.07	27.84
1999/00	1.25	4.62	5.98	0.31	3.39	53.60	30.84

Source: Author's calculation based on Bangladesh Bank data

On the other hand, **nontraditional exports** (i.e., exports of goods other than traditional ones) dramatically grew in importance from 3 percent of total exports in 1972/73 to more than 90 percent in 1999/00. Among the nontraditional exports, **RMG including knitwear** rose to 54 percent during 1999/00 from an insignificant level in the early 1980s. The share of **frozen food** increased from less than 1 percent to 6 percent during the years. Frozen food's share in total exports was higher in the 1980s but its later decline reflected a deceleration in its growth performance in recent years. **Residual export category** showed a big jump in export importance from 1.8 percent in 1972/73 to 31 percent in 1999/00.

Table 4.2
Composition of Imports by Commodity Groups

(% of Total Import Payments)

Year	Consumer Goods	Materials for Consumption	Non-development Imports	Capital Goods	Materials for Capital Goods	Development Imports
	A	B	(A+B)	C	D	(C+D)
1973/74	57.3	18.4	75.7	18.1	6.2	24.3
1974/75	49.9	21.3	71.2	16.7	12.2	28.9
1975/76	35.8	29.4	65.2	19.6	15.3	34.9
1976/77	23.9	37.5	61.4	27.8	10.8	38.6
1977/78	41.1	30.3	71.4	21.4	7.2	28.6
1978/79	18.8	42.0	60.8	18.4	20.8	39.2

1979/80	27.2	34.6	61.8	17.9	20.3	38.2
1980/81	17.9	40.3	58.2	26.9	14.9	41.8
1981/82	24.6	33.2	57.8	30.4	11.8	42.2
1982/83	26.3	34.6	60.9	29.3	9.8	39.1
1983/84	26.8	36.6	63.4	26.6	10.0	36.6
1984/85	32.5	38.4	70.9	12.5	16.6	29.1
1985/86	32.8	36.1	68.9	12.3	18.8	31.1
1986/87	32.3	32.8	65.1	13.4	21.5	34.9
1987/88	37.2	35.0	72.2	10.6	17.2	27.8
1988/89	34.5	33.0	67.5	11.8	20.7	32.5
1989/90	36.0	32.6	68.6	11.5	19.9	31.4
1990/91	34.7	30.1	64.8	14.4	20.8	35.2
1991/92	39.2	30.3	69.5	12.6	18.0	30.6
1992/93	38.3	29.8	68.1	14.5	17.4	31.9
1993/94	41.5	28.9	70.4	12.0	17.6	29.6
1994/95	48.5	27.0	75.5	9.9	14.6	24.5
1995/96	38.6	29.1	67.7	14.1	18.2	32.3
1996/97	28.4	35.1	63.5	15.5	21.0	36.5
1997/98	37.7	28.4	66.1	13.7	20.2	33.9

Source: BBS, Statistical Yearbook of Bangladesh (various issues)

The above trends indicate that Bangladesh's export performance over the last three decades was not spectacular. Despite repeated emphasis of the government on an export-led growth and the introduction of several export promotion measures, the share of exports in GDP persistently remained below 10 percent. Roy (1991) shows that both demand and supply factors are responsible for the ordinary performance of the export sector. Exports of traditional items are demand determined, while some of the non-traditional exports are supply constrained.

Table 4.2 reports data for imports of Bangladesh by types of commodities for the last three decades. It reveals that bulk of Bangladesh's imports is consumer goods and materials for consumption. This category of imports constitutes more than two-thirds of total imports in the 1970s and 1980s. Because of their nature, most of these goods were used for non-development purposes. The share of consumer goods in imports increased significantly in the 1980s following the liberalization of external trade. One factor that might have influenced import liberalization of consumer goods was the sizeable influx of remittances from Bangladeshi migrant workers especially in the Gulf countries. The rest one-third of imports are capital goods and materials for capital goods used for development activities.

V. Export Incentives: An Evaluation

Over the years, the government has provided various incentives to the exporters with a view to make their products more competitive and expand the narrow export base. However, the above analysis of growth and composition of exports raises questions about the effectiveness or adequacy as well as appropriateness of the export policies and the overall export promotion strategy of the government.

Successive governments introduced several export promotion measures, replaced or modified past measures to ensure a competitive edge for the export products and exportables. Some of them include: (a) special or supervised bonded warehouse facilities; (b) duty drawback facilities; (c) a cash compensation benefit in lieu of duty drawback on raw materials – the latter benefit applied only to textile fabrics; (d) duty exemption on capital goods applied to recognized (100%) export-oriented industries; (e) income tax concession; (f) credit support from an export development fund; (g) export credit guarantee scheme; (h) foreign exchange retention benefit for exporters; and (i) development of export processing zone (EPZ) facilities.

Between the two kinds of **bonded warehouses** – Special and Supervised – the latter system is available to the garment sector which has been one of the major factors instrumental for growth of the sector since 1978. However, extension of the system to other export products has been constrained mainly due to resistance from customs authorities. The customs authorities prefer the provision of Supervised Bonded Warehouses to other export products. However, the exporters do not feel comfortable with such facilities due to well-known problems that they face in dealing with the customs officials. In fact, the latter type of bonded warehouses is hardly availed by the export producers except a very small number of industries such as leather goods, electronic goods, computer hardware and software, staffed toys, etc., which are yet to make any substantial contribution to total export growth. Hence, the bonded warehouse system, notwithstanding its potential as a major instrument to expansion and diversification of the export base, is yet to exert any perceptible impact on export growth.

Exporters of certain products such as RMG, specialized textiles, etc. can open letter of credit on a back-to-back basis for the importation of raw materials and other accessories through authorized dealers (commercial banks) without prior permission of the Bangladesh Bank. Under the system, an exporting firm can open an import letter of credit to the extent of 75 percent of the net f.o.b value of export letter of credit. This facility of importing against an export order is in

effect a foreign exchange credit for the interregnum between the time period the exporter opens the import letter of credit and the time period he can pay the supplier of the imported raw materials from the proceeds of his exports.

The special bonded warehouse system and a back-to-back letter of credit system coupled with available quotas in the US market, and GSP in the EU market – helped in rapid growth of the RMG sector. The back-to-back letter of credit has been extended to a broad range of export industries since 1986/87. Insofar as the RMG industry is of a footloose migratory nature requiring not much capital and where the buyers find it easier to rapidly switch to new cheaper sources of supply, Bangladesh gained advantages in the past and expanded RMG exports rapidly. It seems, however, that many of these advantages are fast evaporating for this important and so far rapidly growing sector. Bangladesh is facing fierce competition from both old, more rapidly growing and newly emerging suppliers to the world market such as India, Pakistan, Sri Lanka, Nepal, Vietnam, Cambodia, Laos, Mexico and the Dominican Republic. Furthermore, garment exporters also emphasize that part of the competitiveness edge that Bangladesh has so long enjoyed has been lost due to more aggressive exchange rate adjustments by some of its major competitor countries.

Even though it partly made up for the decline in the growth of garments of woven fabrics in the past, there has been a visible recent deceleration in the very rapid growth of knit garments. The EU has threatened to withdraw GSP facilities for not practicing the three-stage backward linkage compliance in reality. By utilizing the natural advantage of homegrown cotton, countries such as India and Pakistan are now coming up in a big way in the exports of garments made of both woven and knit fabrics. They have also expedited the opening-up of their economies through dismantling of earlier barriers to exports and needed imports and encouragement of foreign investments and expansion of domestic markets which enable them to reap a special advantage by applying marginal pricing to exports.

Administered and coordinated by the Duty Drawback and Exemption Office (DEDO), there are two variants of **duty drawback system** viz., drawback at actual rate, and drawback at flat rate. The system has been plagued with serious problems and has been of limited value to exporters in general. The flat-rate variant in place has been a preferred option to the exporters. It is easier and quicker to avail by the exporters as it is paid on the basis of a rate determined on the

f.o.b. value of the exported products according to input-output coefficients. However, the coverage of export products under the system has not been expanded rapidly due to capacity constraint of DEDO. From the mid-1990s, the number of products including sub-items has only doubled to around 1000.

Even as a better variant, the flat-rate drawback system has not ensured a full tax offset to the exporters as it involves significant cost to them in terms of delays higher than the officially set limit of a week and/or unofficial side payments. To quicken the process of duty refunds, the government introduced a system of repayments of the drawback from banks on 13 items effective from October 1995.[1] While some of these items are no longer exported, exports of other items have been small or insignificant and slow. Inclusion of additional items has not been considered for more than a year. Further, the system can at times become more disadvantageous to exporters if the world prices of imported inputs go up disproportionately with the product prices and/or if the duty and other payable tax contents on imported inputs turn more unfavorable to them and the flat rates are not updated accordingly. Duty drawback at actual rates is required by exporters of items where flat rates are still not determined and for export products newly entering the export market. However, the general experience of exporters with this type of drawback has been very unsatisfactory due to long delays in getting repayments and other costs.

Other measures introduced to ensure duty-free status to both finished products and imported capital goods are the withdrawal of export duties in the 1995/96 budget and a similar extension of the duty-free status accorded to imported capital machinery which was formerly enjoyed exclusively by industries located in EPZs to hundred percent export-oriented industries outside the EPZs. The hundred percent export-oriented industries have been redefined to include those that export upto 80 percent of their total output. However, firms exporting less than 80 percent of their output are not yet entitled to duty exemption on capital goods on a pro-rata basis.

A **cash compensation system** in lieu of duty drawback has been in place for the ready-made garment sector since 1987/88 for using locally produced fabrics used in this sector for export purposes at a rate of 15 percent of the f.o.b. value of final exports of ready-made garments. Effective from 1993/94, the assistance has been reset at a rate of 25 percent of the

[1] The items are (1) crust and finished leather; (2) jute goods/carpets; (3) urea fertilizer; (4) ceramic/melamine goods; (5) espadrilles (jute-made sleepers); (6) transfer paper; (7) tea chest; (8) printed calendar; (9) stainless steel cutlery; (10) cigarettes; (11) newsprint; (12) furnace oil/naphtha; and (15) cardpin (a jute mill spare part).

value of fabrics. The coverage of the assistance has also been expanded to composite textile units if the fabric is produced and garments made in the same unit which exports the garments. It may be noted that during the 1989/90, two other industries – frozen food and crust and finished leather -- also received cash assistance in lieu of the duty drawback/bonded warehouse facility. From the mid-1990s, exporters appear to have preferred to switch from duty drawback/bonded warehouse facilities to cash assistance system since exporters receive more benefits from the system than from the duty drawback or bonded warehouse system.

The fundamental problem with these special tax offsetting measures is that they do not, in general, ensure a full tax offset status to the exporters because (i) the exporters have to incur significant transaction costs to get tax refunds, and (ii) they do not compensate the exporters for the protection-laden extra cost they have to incur on domestically purchased inputs. In some cases, the existing privileges are also abused through leakages of duty and tax-exempted raw materials into the highly profitable domestic market. Another significant drawback of these special duty drawback and bonded warehouse measures is that, due to non-coverage or inadequate coverage of domestic inputs, they have an in-built bias against backward integration of the export industries. And such measures are essentially inequitable and economically inefficient because of non-uniform treatment or differential advantages that the exporters receive due to deficiencies of the existing measures as well as in the system of their administration.

Before 1995/96, exporters were eligible for income tax rebates at varying rates up to 50 percent of the tax attributable to income from exports. Since then, they are entitled to a 50 percent deduction of the income from exports from the taxable income. Handicrafts are fully tax-exempt. The advance income tax payable on the value of exports of garments has been reduced to 0.25 percent from 0.5 percent applied previously. The income tax concession is a significant incentive for established exporters who are already making profitable export business and have reached the taxable phase in their business after the expiry of the tax break period of 5 to 7 years which they usually enjoy.

The income tax concession is both an inadequate incentive and is discriminatory between different businesses in a world characterized by a highly distorted pre-tax rate of return situation with a wide variation in the resulting effective rates of protection in different sectors created by the existing trade and tariff regime. The incentive system has also a significant bias against

production for the export market. It is a questionable incentive also in terms of the cost forgone and the lost government revenue. Instead of such a concession, a straight reduction in the corporate tax rate for both export production and production for the domestic market would be a more transparent and, depending on the extent of tax rate reduction, a stronger incentive for investors, especially for foreign investors. In a situation of lavish tax exemption through the existing tax holidays coupled with a wide practice of tax evasion, a tax concession has little incentive impact. At any rate, a tax incentive should also be accompanied by a rationalization of the trade regime in order to minimize resulting distortions in the incentive effects.

As a support to boost exports, commercial banks provide credit support to the extent of 90 percent of the value of confirmed and irrevocable letter-of-credit at a rate of 7 percent for selected non-traditional export items and at 12 percent for a few traditional export items. A revolving US $ 30 million **export development fund** with an IDA contribution of US $ 25 million was established in the beginning of the 1990s for the purpose. Even though the initial use of the fund was not satisfactory, the present use in reported to have picked up. There may now arise a case for expansion of the fund to lend further financial support to the exporters.

An **export credit guarantee scheme** has long been in operation to provide insurance against possible losses resulting from various types of risk. Currently, three kinds of guarantees viz. (a) pre-shipment export finance guarantee, (b) post-shipment export finance guarantee, and (c) comprehensive guarantee are available through Sadharan Bima Corporation. While the first two types of guarantees are extended to the banks, the third one is given directly to the exporters. However, the scheme has not yet succeeded to have any significant impact on new export development. The scheme could create some appeal to the exporters if its insurance cost could be fully or significantly subsidized from government funds.

The development of **export processing zone (EPZ) facilities** does have significant appeal to prospective investors, more especially to foreign investors. It has well-known special advantages for foreign investors. Rapid expansion of such facilities would be highly desirable as an effective mechanism to promote export development as well as to spur industrial development of the country. The country has so far developed only two such zones viz. Chittagong EPZ and Dhaka EPZ. The authorities should give more emphasis on rapid expansion of such facilities including development of new zones with or without foreign support. Exports from the existing

two EPZs have grown much more rapidly than total exports in recent years and currently such exports account for nearly 10 percent of total exports.

Exporters can now retain upto 40 percent of their export earnings for general exports from earlier 25 percent and 7.5 percent for low value-added exports including garment exports from earlier 5 percent. Although this **foreign exchange retention benefit** has immense potential as an incentive, it hardly raises the rate of return on export activities. Besides, a **special subsidy** provided to jute goods exports during three years, 1989/90 through 1991/92, was lowered from around 12 percent of export earnings in 1989/90 to about 6 percent in 1991/92. It may be noted that commodity-specific subsidies, though encourage the production and export of subsidized items, violate the principle of comparative advantage and go against market principles and eventually become counter-productive. Such commodity-specific incentive structure needs to be avoided as far as possible. For instance, the government spent about Tk 2.8 billion for subsidy on jute goods during the three years (1989/90 to 1991/92). Despite the subsidy, jute goods exports failed to avert the slide or virtual stagnancy in such exports starting after 1984/85 perceptibly due to a falling demand in the world market.

It is evident that the special export promotion measures are inadequate in their coverage, economically inappropriate or discriminatory in their nature and inequitable in their effects on different activities due to inherent deficiencies in the design of such policies and/or problems with their implementation and administration. Often the government has tried to deal with export problems of particular industries with special commodity-specific measures. However, commodity-specific measures run the risk of being misplaced when the activities concerned are beset with sector-specific problems. In businesses, some activities may lose ground and incur losses either because of declines in demand or increases in supply costs, which cannot be attributed to any inappropriate changes in government policies. It will not be an appropriate government policy to try to resolve the problems of such activities with special measures that are unlikely to make the activities concerned economically viable enough to produce any positive impact on their export growth. The past experience indicates that the special measures have failed to produce an export thrust and are unlikely to do so in the foreseeable future.

VI. Changes in Import Policies

The experience of the East Asian economies highlights the importance of a liberalized trade regime in promoting industrialization and overall development. It is now increasingly argued that, regardless of what other countries' policies are, it is in its best interest for a country to unilaterally undertake trade liberalization measures. For Bangladesh, trade liberalization is of strategic importance to create conditions under which the economy can move onto a rapid growth path. Between 1972 and 1994, Bangladesh's share in the growing world exports has dropped from 0.09 percent to 0.06 percent, in contrast to significant improvements made in respective shares of several developing countries such as China, Indonesia, Thailand, Mexico, and the Philippines[2]. It is through adequate reduction of trade policy-created distortions in economic incentives in production sectors and promotion of competitive efficiency that export-led growth in Bangladesh can best be promoted. Rapid export-led growth also leads to an enlargement of the domestic market and creates scope for further growth of efficient import-substituting industries and development of backward linkages from the expanding export industries. In recent years, Bangladesh has made significant progress in reforming its trade regime. However, the progress in reforms made so far remains substantially incomplete to shift incentives firmly toward export production.

Quantitative restrictions (QRs), though removed from most imports, still remain on a number of products, especially on textiles, which *prevent the development of backward linkages with the ready-made garment sector*. Similarly, restrictions on imports of sugar, salt and some other commodities encourage large illegal imports from India (World Bank, 1996). Removing these restrictions would expose these industries to greater competition, generate tariff revenues and benefit consumers by reducing prices. Dismantling of QRs was advanced significantly since the first quinquennium of 1990s. While imports of as many as 2306 items (at HS – 8 digit level) were controlled in 1987-88, the number was reduced to 117 at the beginning of the second quinquennium of 1990s (Bakht, 2001). Despite recent reforms, Bangladesh's trade regime continues to be more complicated and protectionist relative to other liberalized economies: about 30 important product groups were still subject to protective QRs by the end of the first quinquennium of 1990s (World Bank, 1996).

[2] IMF Financial Statistics quoted in World Bank, 1996.

Rationalization of tariff structures carried out so far, no doubt, looks substantial in quantitative terms. However, in a substantive sense, progress achieved in the reform has been limited. Operative tariffs, many of which were prohibitive and not always effective, have been substantially slashed. The top customs duty rate has been brought down to 45 percent from a level of 350 to 400 percent in the past and 75 to 100 percent rates maintained on many items in recent years and most of other lower duties have also been cut. Other improvements include replacement or phasing-out of cascade-type multiple-rate sales taxes on imports and excise taxes on domestic products by a value added tax (VAT), a substantial compression in tariff rates, reduction of user-defined tariff distinctions and simplification and improvements in import procedures including a shift toward use of import values determined by a system of pre-shipment inspection (PSI) scheme by selected government-appointed reputed foreign firms replacing the use of officially determined "tariff values" for purposes of assessment of duties and taxes by customs officials.

Tariff reform still has not gone far enough. Bangladesh's tariffs are considerably higher than those in more successful developing countries in East Asia and Latin America. The average unweighted protection rate is 25 percent in Bangladesh (1995), compared with 10.3 percent in Sri Lanka (1995), 11 percent in Chile (1991), 12.2 percent in Argentina and 14 percent in Malaysia (World Bank 1996). In Bangladesh, the tariff rates in 1994/95 were widely dispersed; and the tariff structure continued to be distorted with end-user concession categories and continued substantial use of tariff values (World Bank, 1996). No significant changes were made thereafter. Import tariffs on numerous finished consumer goods and many intermediate products still remain at high levels. These tariff rates have not been reduced satisfactorily either because the authorities are reluctant to reduce protection to existing domestic industries significantly or they attach too much attention to possible negative effect of tariff cuts on government revenue. On the other hand, while the highest tariff rate is 45 percent, very low or zero tariffs are maintained on numerous products. The zero-duty items have been considerably expanded in the last few years. Because of continued QRs and relatively high rates of tariffs on numerous products, many import-substitution industries still remain highly protected (Rab, 1997).

The unsystematic reduction in tariff rates and effecting greater reduction in tariffs on raw materials and intermediate inputs than in those on finished goods has resulted in high effective protection rates (EPRs) for many industries. Tariff dispersion, as measured by the coefficient of

variation, increased from 62 percent in 1992/93 to 73 percent in 1995/96 (World Bank, 1996). This has been due to an increase in the concessional duty rates, lowering of duties on industrial and agricultural inputs and increase in the number of zero-duty goods.

The continued use of a cascaded tariff structure with higher tariffs on outputs than on inputs has been a source of serious distortion in prices and discrimination in incentives between different activities. Since assembling and light manufacturing activities can have value added as low as 1 to 20 percent, even a 15 percent tariff on output combined with zero tariff on inputs can result in very high EPRs – in the range of 75 percent and 1,500 percent (Rab, 1995). The EPR depends not only on the absolute level of the nominal tariff on output but also on the spread between the output tariff and the input tariff. Such inter-sectoral and industry-wide intra-sectoral differences in trade policy-created incentives have widened over the years resulting in greater policy distortions (Rab, 1995). It is necessary to consider differences in effective protection rates (EPRs) that might result from cascaded tariffs since EPRs provide signals that influence investors' choices of activity. It is argued that the cascaded structure of the tariff system can have as much or more impact on the pattern of incentives as the levels of tariffs (Robertson, undated).

Further tariff reform is needed in the form of scaling down of relatively high tariffs and rationalization of the entire tariff structure through reduction of wide dispersion in tariffs and removal of existing anomalies of tariffs on outputs and inputs. The needed rationalization of the tariff structure should also include: (1) elimination of current, (and still substantial) use of officially set "tariff values" for valuation of imports for duty and tax assessment purposes, which often produce additional protective effects for domestic production; (2) removal of extra-duty of 2.5 percent for LCA (letter of credit authorization) or import permit fee (or its merger with customs duties); and (3) rationalization of the VAT and supplementary duties to make them trade-neutral. In late 1994, the Government introduced a voluntary preshipment inspection (PSI) scheme authorizing some designated foreign firms to perform the task of valuation of imports.

Two relevant policy conclusions can be drawn from the foregoing discussion on trade regime: (a) the trade regime still retains a substantial bias against production for export, despite its ostensibly significant reform in recent years; and (b) tariff and nontariff restrictions on imports also continue to distort the exchange rate keeping the domestic currency overvalued, which works against production for exports.

The anti-export bias comes mainly from still high effective protection received by many domestic industries for sale in the domestic market, while that received for export is either close to zero or negative. Yilmaz (1996) estimated EPRs for production sold domestically for 14 industry or product groups of Bangladesh for 1992/93 and 1995/96 using data from the World Bank manufacturing survey of 1992/93. These estimates show that most products receive substantial EPRs (over 65 percent) – among which, steel and engineering, food and dairy, perfumes and toiletries and textile received EPRs ranging between 73 and 123 percent, even in 1995/96. Maintaining an overvalued domestic currency hurts production not only for export but for the domestic market as well.

The Government should no longer delay the vitally required trade reforms. The remaining trade-related QRs on imports should be removed. The highest operative tariff rate (customs duty rate) should be slashed to no higher than 20 percent along with elimination of the use of officially set tariff values for valuation of imports and its replacement by a mandatory PSI system at government cost, removal of non-customs duty levied on imports such as LCA/import permit fees, rationalization of supplementary duties to make them fully trade-neutral and imposition of the unilateral VAT on imports and on domestic products. The zero customs duty rate should be withdrawn for all products except for those used in production for the export market. A swift move should be made to jack up all duty rates to 20 percent level, while for an interim period maintaining a maximum of two rates nearer to 20 percent, with the lowest rate set at, say, 10 percent.

VII. The Exchange Rate Regime [3]

As a part of the policy, trade liberalization can be accompanied by exchange rate reform to retain sufficient protection to domestic production activities for both domestic and export markets. There is a close link of trade reform with exchange rate reform. The interconnection between trade and exchange reforms follows from the simple relation that the nominal effective exchange rate for imports is the sum of nominal exchange rate and weighted average nominal import tariff per dollar worth of imports. The effective nominal exchange rate for exports is

[3] This section draws on the author's unpublished M Phil dissertation submitted to the University

likewise the sum of nominal exchange rate and the weighted average nominal subsidy, if any, per dollar worth of exports. There is in fact a two-way relation between trade reform and exchange rate reform. Trade reform affects the real exchange rate and requires adjustment of the nominal exchange rate. On the other hand, exchange rate reform can help further trade liberalization by providing at least some compensation for the loss of protection to domestic activities through trade liberalization. Maintaining a competitive real exchange rate and adjusting the nominal exchange rates accordingly is critical to ensuring competitiveness of traded sectors of the economy. An exchange rate adjustment (devaluation) is a much better instrument to use than special tariffs for imports and subsidies for exports for domestic protection purposes since it is non-discriminatory across all (both import-substitution and export) activities. It imparts an added external competitive edge to domestic production in the form of lowering the cost of non-traded inputs in foreign exchange terms.

After independence in 1972, Bangladesh initiated several measures with respect to exchange rate policy. The country started with a pegged exchange rate policy when the newly introduced national currency, the Taka (Tk.), replaced the Pakistani Rupee on a one-for-one basis. The currency was pegged to Pound Sterling and was set at par with the Indian Rupee. In the same year, the country became a member of the *Sterling Area.* Even after the collapse of the Pound and dismantling of the Sterling Area in mid-1972, the Taka maintained its link with the Pound Sterling thus depreciating vis-a-vis the US Dollar. This rate remained unchanged until May 1975 when a major devaluation of the domestic currency was carried out. The UK Pound Sterling remained the intervention currency until January 1983. During this period of trade protection regime, the Taka virtually remained on a free float like the Pound Sterling unless the rate was deliberately changed (as in 1975) and in minor ways from time to time. In August 1979, Bangladesh switched to a 'basket method' of exchange rate determination with fluctuation margins of 2.5 percent on either side; the margins were subsequently squeezed to 1 percent in 1980. The basket consisted of four currencies, viz. Deutsche Mark, Japanese Yen, US Dollar and UK Pound Sterling, as a reference. Until 1983, the four-country-basket currencies were assigned some predetermined weights by a rule of thumb method.

In 1983, the Taka severed link with the Pound Sterling and the US Dollar was chosen as the intervention currency. The frequency of peg adjustments was also made more pronounced since 1985 to make it consistent with the 3-year IMF-SAF program. During the period, the

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of Strathclyde, UK, 1999.

number of currencies used as a reference basket was increased to six with the inclusion of the Indian Rupee and the Pakistani Rupee with existing four currencies. A trade-weighted basket concept for estimating a real effective exchange rate (REER) with the six-currency basket came into being since 1983. However, the methodology used for estimating the REER was different from the one that was adopted since July 1989. During the period 1983 – June 1989, the trade weights used were those of the period of January – March, 1983. Since July 1989, the country coverage was increased to 10 with the inclusion of four more countries, Canada, South Korea, Singapore and Thailand. The trade weights used were the averages for the years 1986/87 and 1987/88. The practice continued, till the fiscal year ending in June 1994. The present practice of estimating the REER with a 15-country coverage with addition of five more countries and with an extra weight assigned to the unofficial cross-border trade with India commenced from the fiscal year 1994/95. The countries are Belgium, Canada, China, France, Germany, Japan, Hong Kong, India, Italy, Netherlands, Pakistan, Singapore, South Korea, UK, and the USA. The Taka was made convertible in October 1993 for officially permitted current account transactions, which met the International Monetary Fund (IMF) Article VIII obligations.

A system of maintaining limited flexibility in the exchange rate was first introduced in the early 1980s, with certain improvements introduced into the system in late 1980s and early 1990s. However, there remains considerable room for further liberalization of the exchange regime and for improvement in exchange rate management. The nature of current account convertibility remains significantly deficient because of existing tariff and non-tariff import restrictions and with continuation of existing controls on several kinds of transactions such as (1) restriction on private borrowing from abroad unless it falls within officially set specified terms; (2) restriction on reconverting retained foreign exchange earnings of exporters once used in meeting local expenses; (3) restriction on the exporters' access to cash foreign exchange if they operate on back-to-back letter of credit arrangements; (4) restriction on access to foreign exchange for imports other than through letters of credit; (5) limits on foreign exchange available for personal and business travel; and (6) restrictions on remittances abroad for miscellaneous family and dependents' expenses. In addition, more restrictive controls exist on capital transfers. Controls on the latter transactions have not been removed substantially other than for some officially specified ones.

Insofar as the policy relating to exchange rate management is concerned, Bangladesh moved, effective January 1992, from what was essentially a multiple exchange rate system to a unitary one. While prior to 1993, the Bangladesh Bank used to fix exchange rates for all types of foreign exchange transactions, it loosened this centralized grip since 1993 for interbank dealing rates in foreign exchange and individual bank quotations to their customers. However, the Bangladesh Bank retains its authority to fix the buying and selling rates of foreign exchange from it by authorized dealers. The centralized control on the exchange rate basically determines the exchange rates faced by both importers and exporters and those who remit or bring in foreign exchange into the country or take foreign exchange out of the country.

The existing practice of exchange rate management has serious shortcomings and does not lead to maintenance of a satisfactorily competitive real exchange rate system in relation to corresponding policies followed in other countries competing significantly with Bangladesh in both domestic and external markets. Furthermore, the exchange rate policy is not adequately linked to progress in trade policy reform and reform of the foreign exchange regime with progressive relaxation of exchange controls. Also the exchange rate reform has not been effectively used to accelerate trade policy reform. During the last two years, there had been an import boom following large increases in both private and public imports, which was not matched by commensurate export growth and was financed by a significant depletion of the foreign exchange reserve. Import growth has sharply decelerated in the first six months of the current fiscal year. During the same period, export growth also showed a significant slowdown. In order to remedy the situation, the government devalued the Taka several times in small doses during the period. But the devaluation was not significant enough to create any tangible effect. Maintaining a more competitive exchange rate policy remains a key reform to be carried out in future as this will not only impart greater competitiveness to traded sectors of the economy and boost prospects for higher growth, but will also create scope for further trade liberalization and reduction in the bias against exports. This will also increase the prospects of higher export-led growth, besides restoring or maintaining the external balance.

The exchange rate regime is an important macroeconomic policy issue for the economy. The policy makers often do not put enough weight to the costs of an inappropriate exchange rate management to the economy. An overvalued or uncompetitive exchange rate depresses prices of the traded sectors relative to those in other countries competing with Bangladesh in these

products in both export and domestic markets. Maintaining a realistic and competitive exchange rate is an important policy imperative for Bangladesh.

Rab (1993) raises several questions about appropriateness of the exchange rate management policy in Bangladesh. He maintains that exchange rate management in the past has been less flexible and competitive. In particular, he refutes the usually cited arguments against more flexible exchange rate management such as a satisfactory foreign reserve situation, import-dependence of domestic industries, and worsening of inflation. It is suggested that such arguments are overemphasized at the expense of a greater cost to the economy in terms of a sluggish performance of the traded sectors of the economy and consequently lower economic growth. Yunus (2001) shows that misalignment in the real exchange rate hurts exports and investment of the country to a significant extent.

It thus appears from the above that no consistent policy has been followed in Bangladesh for exchange rate management since independence. The criteria adopted for determining the nominal exchange rate from time to time are also not clear. Neither a systematically uniform or appropriate approach has been applied to estimate the REER indices nor such indices have been used as a principal guide for time-to-time adjustment of the nominal exchange rate. It seems that the foreign exchange reserve situation, which has been influenced by foreign aid and other capital flows including remittances and merchandize trade (import and export) flows, has been an important consideration alongside REER movement (which has not been appropriately estimated always) in exchange rate adjustments. For a long time, the value of Taka has been unduly influenced by capital flows, export growth dominated by a single product group (ready-made garments) and import growth affected by a plethora of import controls and other regulatory and policy problems in the economy.

In such a situation, the exchange rate management could not be sufficiently flexible to attain and maintain a realistic and competitive real exchange rate. The exchange rate in fact remained appreciated by aid, capital and remittance inflows. The domination of export growth by only a few product groups (jute and jute goods in the 1970s and early 1980s and readymade garments afterwards) has also influenced its movements over the years. To address the exchange rate problem, successive governments drew-down on the foreign exchange reserve, and extensively used tariff and non-tariff restrictions on imports including the use of inappropriate

import control instruments such as margins on the opening of letters of credit for imports – sometimes combined with credit restrictions – and stringent restrictions on access to foreign exchange for capital-account transactions. As a result, the growth of the economy suffered due to an inappropriate exchange rate with an overvalued Taka.

Table 7.1
Real Effective Exchange Rate and Misalignment

Year	REER[a]	Inter-year Fluctuations	Misalignment[b]
1973	55.97	-	-
1974	41.50	-14.47	35.18
1975	65.78	24.28	22.43
1976	68.24	2.46	12.11
1977	70.80	2.55	11.50
1978	77.57	6.78	11.55
1979	80.17	2.60	11.41
1980	82.63	2.46	11.61
1981	87.57	4.94	8.28
1982	95.01	7.44	3.76
1983	89.35	-5.66	2.33
1984	80.87	-8.49	3.12
1985	97.04	16.17	2.23
1986	91.31	-5.72	2.30
1987	96.17	4.86	3.36
1988	92.69	-3.48	4.09
1989	86.22	-6.47	5.02
1990	100.00	13.78	3.74
1991	103.89	3.89	2.90
1992	97.48	-6.42	1.47
1993	100.86	3.38	0.23
1994	103.92	3.06	0.05
1995	103.83	-0.08	0.79
1996	109.19	5.36	-0.28
1997	104.49	-4.70	6.18
1998	105.47	0.97	2.21
1999	134.01	28.55	5.07

Sources: a. Author's calculation based of IFS CD-ROM data.
b. Author's calculation based on Yunus (2001).

Following the present practice of the Bangladesh Bank, the annual series of real effective exchange rates (REERs) estimated for the period since 1972/73 is presented in Table 7.1. The series of REER indices have been estimated using the trade weights of Bangladesh's 15 most important trading partners and making the same additional allowance for unofficial trade with India as is currently made in the Bangladesh Bank REER estimation practice.[4] The results from the series show a consistent pattern of inter-temporal movements in the REER index and considerable year-to-year fluctuations in the relative REER movements during the 29-year period. Specifically, REER appreciated in 9 of the 29 years. A considerably high rate of REER appreciation – in the range of about 15 percent – was effected in 1973/74. This was followed by a considerable REER depreciation during the next year of about 24 percent. The years that followed thereafter till 1983/84 generally show, with some exception, a modest total REER depreciation of about 2 to 7 percent. There is a sudden jump in the REER depreciation in 1984/85 – a depreciation of 16 percent. The highest depreciation was 29 percent in 1999/00.

These results reflect the influences of deliberate nominal devaluation (or revaluation) actions taken from time to time in terms of the intervention currency used during the period and appear to have been affected by the choice of the intervention currency and time-to-time fluctuations in the relative values of various currencies in the international currency market and inflation situations in trading partner countries relative to Bangladesh.[5] The results largely reflect the general orthodox approach applied by the authorities to exchange rate management. The observed relatively large early-period REER depreciation was mainly due to a massive (37 percent) devaluation in May 1975. It is striking to note that the early-period REER depreciation coincided with a period when the Pound Sterling remained weak *vis-a-vis* other currencies, especially a strong US Dollar. A nominal devaluation in terms of a weak Pound, the intervention currency used during the time, translated into a strong devaluation in terms of other stronger currencies. The present REER estimates largely correspond to the estimates by Stern, Mallon and Hutcheson (1988) and Intal (1992).

[4] Unofficial trade (value) with India is treated as equivalent to the size of the official trade. However, a recent survey by the BIDS as reported in World Bank (1996) suggests that the unofficial trade accounts for as much as 13 percent of the total official trade. This would imply that the current Bangladesh Bank practice assigns a lower weight to unofficial trade than what would seem to be more appropriate. However, as we are estimating REERs for a long time period and since relative unofficial trade flows can vary from time to time, we have been content with the conservative Bangladesh Bank approach being applied.

[5] During the early period up to 1982/83 when the Bangladesh Taka was pegged to Pound Sterling, some occasional revaluations were effected against the Pound Sterling.

The exchange rate management in Bangladesh appears to be considerably influenced by consideration of the rates in the parallel market in relation to the official ones. This is done presuming that the official rate keeps an equilibrium in relation to the parallel market rate (Yunus, 1997). Bangladesh's exchange rate management, however, needs to be more flexible and competitive than it has hitherto been. *It is necessary for Bangladesh to maintain the exchange rate at competitive levels to ensure external competitiveness to traded sectors on the basis of an appropriately estimated real effective exchange rate (REER) rather than stick to a relatively stable REER policy when other countries competing with Bangladesh in both export and domestic markets are following more aggressive exchange rate policies and depreciating their REERs* (Rab 1997).

VIII. Some Concluding Remarks

The paper highlights that the trade balance of Bangladesh is characterized by changes in trade volume, prices and some unexplained residual factors. All these components contributed to the variability in the balance of trade in the past. While the first two components contributed positively, the residual factor contributed negatively. Of the above three factors, the importance of quantity is significant. Thus the major burden of the country's trade deficits rests on imbalances of domestic origin i.e., supply constraint of major export goods together with ever increasing import demands.

A rapid and sustained long-term export growth is crucial to Bangladesh's success in achieving rapid economic growth. Long-term and recent trends in Bangladesh's exports remain considerably short of the pace needed to generate rapid growth. The overall export promotion strategy pursued so far remains starkly ineffective. Special incentives in place have not worked to produce the desired export thrust. Whatever export growth that has taken place after the mid-1980s, was driven mostly by a spectacular performance of a single product group – ready-made garments (RMGs). It was made possible due to a special enclave environment as well as fortuitous external factors including quota and generalized system of tariff preference (GSP) enjoyed by the product group. The growth trend in residual exports has not been spectacular since the mid-1980s – a reflection of the deficiencies remaining in trade and exchange regimes even after significant reforms in the past. There has been little export diversification. A sharp deceleration in export growth during the last fiscal year reflects disconcerting developments for export growth prospects for the coming years. These developments call for serious

reconsideration -- of the export promotion policies currently being pursued. Commodity-specific approaches, most of which are deficient or vulnerable to abuse and economically inappropriate or discriminatory and inequitable in their effects -- which have so far been used extensively are unlikely to produce the desired export success, as demonstrated in the past.

In Bangladesh trade policy reform – an essential prerequisite for an export-oriented growth strategy – remains substantially incomplete. The highest tariff rate is still maintained at much too high a level and the tariff structure remains widely dispersed with several regular and concessional tariff rates and numerous zero-tariff items. The current structure retains a significant anti-export bias which causes distortions in economic incentives. The quantitative restrictions which still remain on imports -- of textiles and other goods have been an additional factor which distort trade and encourage smuggling.

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